

# Compensation through Ownership: The Use of the ESOP in Entrepreneurial Ventures

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*This note discusses the potential for entrepreneurs to use an Employee Stock Ownership Plan as an alternative or as part of a compensation plan for employees. Benefits and risks of ESOP plans are addressed and analyzed for both S-Corporation and C-Corporation forms. To aid entrepreneurs in assessing whether or not their corporation should use an ESOP plan, an analysis of factors that have been identified to best enable a successful ESOP plan is presented. This note does not seek to endorse the use of ESOP plans for all entrepreneurial ventures, but instead acts as a resource for entrepreneurs who may consider using an ESOP plan.*

## I. INTRODUCTION

The difficult task of attracting and retaining quality employees proves challenging to owners of all businesses, but this difficulty is especially trying for young entrepreneurial companies. How can an entrepreneur convince potential employees that the company is going to be a success? How can an entrepreneur compete with more established companies when recruiting new employees? Using ownership to compensate employees has been adopted in a variety of company settings, from the start-up high tech firm to the well-established airline companies.<sup>1</sup> Entrepreneurs should consider using employee ownership as a portion of

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<sup>1</sup> See generally Corey Rosen, *Sharing Equity Often Overlooked in Pay Debate*, PENSIONS AND INVESTMENTS, Apr. 4, 2005, at 12. By 2002 about forty percent of all U.S. workers working in companies with stock had some form of stock option plan available to them. While some of these companies have flourished (Starbucks Corp., Microsoft Corp., Publix Super Markets Inc., Whole Foods Market Inc., and Southwest Airlines Co.), other companies have faltered (United Airlines Corp., Enron Corp., and WorldCom Inc.). While data does not suggest that the use of employee ownership directly contributed to the failure of the companies, the companies that faltered have been criticized for using broad ownership plans. While employee ownership can help improve financial performance, it can by no means guarantee success.

compensation for employees to aid entrepreneurs in attracting and retaining high quality employees.

When evaluating the different choices available to entrepreneurs for compensating employees, an option that is worth considering is the Employee Stock Ownership Plan ("ESOP"). As discussed in more detail below, an ESOP plan has significant advantages if an entrepreneur determines that employee ownership is an appropriate form of compensation for employees. The ESOP plan enjoys tax savings that increase the benefits to the company and to the employees. Further, it has been suggested that an ESOP plan increases employee morale and efficiency.<sup>2</sup> By creating an incentive for employees to increase performance and productivity, the ESOP serves as a way to improve the profitability and success of the company. ESOP plans are currently being used in a variety of different companies, and in a recent study of companies using ESOP plans over eighty percent of owners claimed to be satisfied with the results of their ESOP plans.<sup>3</sup> The ESOP plan provides entrepreneurs with an exit strategy, but at the same time allows for the business to continue on after the entrepreneur has withdrawn his or her interest.

ESOPs have been formally recognized by the legislature since the 1970s and its popularity has experienced tremendous growth in the last ten years.<sup>4</sup> The legal and accounting complexities surrounding ESOPs have often been cited as reasons why many small business owners avoid their use, but resources are available to aid entrepreneurs and other business owners in translating the ESOP plan requirements into a comprehensible opportunity.<sup>5</sup> While ESOPs have several benefits, there are disadvantages to ESOPs as well. The financial position of the company prior to creating

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<sup>2</sup> *Id.*; see also Dickson C. Buxton & Ronald J. Gilbert, *ESOP: A Four-Letter Word? Liquidity and Perpetuation Pros and Cons*, JOURNAL OF FINANCIAL SERVICE PROFESSIONALS, Nov. 2004, at 84; Christopher A. Kramer, *Is It Time to Consider (or Reconsider) an Employee Stock Ownership Plan?*, EMPLOYEE BENEFIT PLAN REVIEW, Jan. 2004, at 10.

<sup>3</sup> Kramer, *supra* note 2.

<sup>4</sup> See John Case, *The Ultimate Employee Buy-In*, INC. MAGAZINE, Dec. 2005, at 107, 110.

<sup>5</sup> To aid business owners who are evaluating ESOP plans, two organizations exist to enable fully-informed decision making. The National Center for Employee Ownership is a private nonprofit research organization that devotes its time to presenting accurate information on ESOP plans as well as other employee compensation plans. See The National Center for Employee Ownership, <http://www.nceo.org> (last visited Mar. 9, 2006). The ESOP Association is another nonprofit organization dedicated to the promotion of ESOPs. It seeks to act as a network of businesses utilizing ESOPs and create shared resources and knowledge pertaining to ESOPs. See The ESOP Association, <http://www.esopassociation.org> (last visited Mar. 9, 2006). Additional resources include the Beyster Institute for Entrepreneurial Employee Ownership and the Global Equity Organization.

an ESOP plan should be carefully evaluated. ESOPs are not ideal for companies with limited cash flow<sup>6</sup> and can be a costly endeavor.<sup>7</sup> In the following sections the questions “What is an ESOP plan?”, “What are the benefits and risks?”, and “Is an ESOP the right choice for an entrepreneurial venture?” will be addressed.

## II. WHAT IS AN ESOP PLAN?

An employee stock ownership plan is a tax-qualified employee benefit plan in which most or all of the assets are invested in the employer's stock. Like profit-sharing and 401(k) plans, an ESOP generally must include all full-time employees meeting certain age and service requirements. The company can finance the plan through cash contributions, debt the company repays, or share contributions. Employees receive their benefits when they leave the company. Some 10 million people in almost 11,500 companies, most of which are closely held, participate in ESOPs.<sup>8</sup> “An ESOP is like a leveraged buyout. An employee trust borrows against the company's future earnings to buy the business. As the debt is repaid, shares are distributed.”<sup>9</sup> There is a degree of risk associated with leveraging the payment, and the company must be certain that it will have the cash flow to meet these payments.

The ESOP plan offers a great deal of flexibility and tax advantages to business owners. Many owners are turned off from using the ESOP due to the complexity of the transaction or because of the risks associated with using the ESOP. However, the ESOP's benefits can greatly outweigh its risks for many companies. In the following sections, the ESOP is analyzed more thoroughly to help entrepreneurs determine if using an ESOP as a portion of compensation for employees would best suit their business.

“An ESOP is either a tax-qualified stock bonus plan or a combination of a qualified stock bonus plan and a qualified money purchase plan, which is designed to invest primarily in qualifying employer securities and meet additional requirements prescribed by regulation” as defined at Employee Retirement Income Security Act (“ERISA”) of 1974, § 407(d)(6), 29 U.S.C. § 1107(d)(6) (2006); I.R.C. § 4975(e)(7) (2006);<sup>10</sup> 29

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<sup>6</sup> Buxton & Gilbert, *supra* note 2, at 87.

<sup>7</sup> Case, *supra* note 4, at 115.

<sup>8</sup> Corey Rosen et al., *Every Employee an Owner. Really.*, HARV. BUS. REV., June 2005, at 123, 124.

<sup>9</sup> Case, *supra* note 4, at 108.

<sup>10</sup> 26 U.S.C. § 4975(e)(7) (2000). Employee stock ownership plan. The term “employee stock ownership plan” means a defined contribution plan:

(A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under § 401(a), and which are designed to invest primarily in qualifying employer securities; and

(B) which is otherwise defined in regulations prescribed by the Secretary.

C.F.R. § 2550.407d-6 (2006); Treas. Reg. § 54.4975-11 (2006).<sup>11</sup> In the Department of Labor advisory Opinion 83-6A, “primarily” is defined as investing more than fifty percent in the qualifying employer securities.<sup>12</sup> Additionally, the ESOP must be formally designated as an ESOP plan in the plan document.<sup>13</sup>

“The stock held by the ESOP must be ‘qualifying employer securities.’ The definition of ‘qualifying employer securities’ is broader for an unleveraged ESOP than for a leveraged ESOP.”<sup>14</sup> Unleveraged ESOPs must meet the ERISA requirements in § 407(d)(5) that defines a qualifying employer security as “an employer security which is stock, a marketable obligation, or an interest in a publicly traded partnership.”<sup>15</sup> The requirements for leveraged ESOPs to meet the definition of qualifying employer securities are defined at §§ 4975(e)(8)<sup>16</sup> and 409(l) of the Internal Revenue Code (I.R.C.). To meet the definition of qualified employer securities, the security must be

common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market; or if the employer has no readily tradable common stock, then common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights at least equal to the class of common stock having the greatest voting power, and to the class of common stock having the greatest dividend rights; or [n]oncallable preferred stock

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A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of § 409(h), § 409(o); if applicable, § 409(n), § 409(p), and § 664(g); and, if the employer has a registration-type class of securities (as defined in § 409(e)(4)), it meets the requirements of § 409(e).

<sup>11</sup> David A. Pratt, *Focus On... S Corporation ESOPs*, JOURNAL OF PENSION BENEFITS, Autumn 2005, at 49, 50.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* (citing 29 C.F.R. § 2550.407d-6(a)(2) (2006); Treas. Reg. § 54.4975-11(a)(2) (2006)).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* (citing 26 U.S.C. § 407(d)(5) (2006)).

<sup>16</sup> *Id.* (citing 26 U.S.C. § 4975(e)(8) (2000)). Qualifying employer security. The term “qualifying employer security” means any employer security within the meaning of § 409(l). If any moneys or other property of a plan are invested in shares of an investment company registered under the Investment Company Act of 1940, the investment shall not cause that investment company or that investment company's investment adviser or principal underwriter to be treated as a fiduciary or a disqualified person for purposes of this section, except when an investment company or its investment adviser or principal underwriter acts in connection with a plan covering employees of the investment company, its investment adviser, or its principal underwriter.

that is convertible into common stock . . . at a reasonable conversion price.<sup>17</sup>

#### A. *S Corporation Use of ESOPs*

There is a growing trend to use ESOPs in Subchapter S corporations. This trend began with the passage of the Small Business Job Protection Act of 1996 that allowed for ownership of “S corp” shares through “ESOPs” or other “qualified retirement plans.”<sup>18</sup> The significant advantage to using the S corporation and an ESOP plan stems from an S corporation’s ability to pass through earnings to its shareholders. Since an ESOP is a tax-exempt shareholder, the earnings can pass to the ESOP without income tax.<sup>19</sup> The S corporation must use particular caution when using ESOPs due to the potential tax abuses.<sup>20</sup>

#### B. *Other Business Types and the Use of ESOPs*

Partnerships and limited liability companies do not meet the requirements of a qualifying employer security in evaluating ownership interests.<sup>21</sup> If a non-corporate entity changes its federal income tax classification to be taxed as a corporation, however, then the entity will also be classified as a corporation for purposes of determining whether the entity is a member of a controlled group of corporations under § 409(l)(4).<sup>22</sup> “Thus, a partnership or limited liability company that elects to be taxed as a corporation may participate in a leveraged ESOP established by a member of its controlled group.”<sup>23</sup> While the use of the ESOP is limited to entities taxed as corporations, the general use of employee ownership is not limited to C and S corporations. Owners of partnerships and limited liability companies may also use ownership as a means of compensation for

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<sup>17</sup> Pratt, *supra* note 11, at 50.

<sup>18</sup> See Dennis C. Reardon, *ESOPs for S Corporations: An Idea Whose Time Has Come*, JOURNAL OF FINANCIAL SERVICE PROFESSIONALS, Sept. 2005, at 12.

<sup>19</sup> *Id.*

<sup>20</sup> As further discussed in the Benefits and Risks Associated with ESOPs section of the paper, S corporations and their use of ESOPs is an area the IRS has been carefully monitoring. The IRS has become aware of numerous ESOP abuses by S corporations. S corporations were often guilty of violating reporting requirements as well as setting up sham structures. If an S corporation chooses to use an ESOP plan, the company must be careful to comply with the IRS rules. See generally Matthews on 401(k), *IRS Focus on Abusive ESOPs*, 401(K) ADVISOR, Sept. 2005, at 6.

<sup>21</sup> Pratt, *supra* note 11, at 50.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

employees, and this option should be evaluated in a similar manner as the ESOP is evaluated for corporations.

### III. BENEFITS AND RISKS ASSOCIATED WITH ESOPs

The use of an ESOP has the potential to benefit three different parties in the transaction: the stockholders, the company, and the employees. From the article, “ESOP: A Four-Letter Word? Liquidity and Perpetuation Pros and Cons,” the following is a summary of the benefits to these three groups.

#### A. *Stockholders:*

1. Creates liquidity, possibly tax free, at fair market value.
2. Allows control to be maintained ([in the right] circumstances).
3. Provides for tax-free rollover treatment available to seller of privately held C corporation stock.
4. Establishes value and provides liquidity for estate planning purposes.
5. Allows additional corporate equity incentives.

#### B. *Company:*

1. There is a substantial corporate tax savings (40% to 100%), pretax dollars repay the debt, there are tax deductible C corporation dividends, and S corporation stock owned by ESOP is not subject to federal income tax.
2. Cash flow is increased.
3. There is corporate perpetuation.
4. Accumulated retained earnings are justified.

#### C. *Employees:*

1. Employees share directly in equity growth of the company.
2. Company contributions to the ESOP tend to be larger than 401(k) matching or profit-sharing contributions.
3. Studies conducted over the past twenty-five years demonstrate that the ESOP is a proven motivator, which builds unity and team spirit and retains key employees.<sup>24</sup>

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<sup>24</sup> Buxton & Gilbert, *supra* note 2, at 87 (footnotes omitted).

#### D. Tax Benefits

Section 1042<sup>25</sup> of the Internal Revenue Code (“I.R.C.”), enacted in 1984, encourages the use of ESOPs as a means of allowing the entrepreneur a way to depart from the business.<sup>26</sup> “In general, [under § 1042] the shareholder of a privately held company may defer recognition of gain on sale from the sale to the ESOP of a bloc of stock representing thirty percent of the outstanding value of the company, provided the shareholder purchases qualified replacement property within a fifteen-month period.”<sup>27</sup> Unfortunately, the beneficial treatment of § 1042 only applies to C corporations.<sup>28</sup> If a sale to an ESOP fails to qualify under § 1042 for nonrecognition, “the selling shareholders will generally be taxed on their gain at favorable capital gains rates.”<sup>29</sup>

C corporation leveraged ESOPs may also gain because they receive higher limitations on deductions than those offered in similar contribution plans.<sup>30</sup> The ESOP plans can deduct contributions spent for repayment of loan principal, up to twenty-five percent of covered payroll, and under § 404(a)(9) of the I.R.C. can also deduct all contributions to pay loan interest.<sup>31</sup> If an S corporation decides to use an ESOP plan, the S corporation must be aware of the restrictions under § 409(p) of the I.R.C. Section 409(p) “sets forth rules that are intended to ensure that an S corporation ESOP benefits both non-highly compensated employees and highly compensated employees and owners so that the S corporation may not use ESOPs for inappropriate tax deferral and avoidance.”<sup>32</sup> The rules of

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<sup>25</sup> 26 U.S.C. § 1042 (2000). Sales of stock to employee stock ownership plans or certain cooperatives.

(a) Nonrecognition of gain. If:

(1) the taxpayer or executor elects in such form as the Secretary may prescribe the application of this section with respect to any sale of qualified securities,

(2) the taxpayer purchases qualified replacement property within the replacement period, and

(3) the requirements of subsection (b) are met with respect to such sale, then the gain (if any) on such sale which would be recognized as long-term capital gain shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property.

Additionally, 1042(b) expresses the qualifications for nonrecognition treatment and 1042(c) defines the terminology used in the section. See *id.* § 1042(b), (c).

<sup>26</sup> See Michael E. Murphy, *The ESOP at Thirty: A Democratic Perspective*, 41 WILLAMETTE L. REV. 655, 665 (2005).

<sup>27</sup> *Id.*

<sup>28</sup> See Pratt, *supra* note 11, at 52.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 51.

<sup>31</sup> *Id.*

<sup>32</sup> Reardon, *supra* note 18, at 13.

§ 409(p) prevent using an ESOP plan when there is a concentration of stock ownership among disqualified owners.<sup>33</sup>

While certain tax benefits exist solely for the benefit of C corporations, S corporations do have the tremendous benefit of tax deferral.<sup>34</sup> The S corporation stock that is held by the ESOP is not taxed on the distributive share of income, regardless of whether or not the income is distributed.<sup>35</sup> Originally, § 512(e) of the I.R.C. treated income from the ESOP stock as unrelated business taxable income, but under the Tax Reform Act of 1997 (“TRA”) this income became exempt from taxation.<sup>36</sup> This exemption from unrelated business taxable income gives S corporations a significant benefit that is not available to C corporations.

[T]he exemption from the Unrelated Business Taxable Income (UBTI) tax for ESOPs does more than simply eliminate double tax on S corporation income attributable to stock held by an ESOP. . . . [T]he tax deferral provided by this arrangement effectively eliminates tax on the S corporation’s earnings and provides for an individual-level tax that is equivalent to a qualified pension plan freed from the contribution limits of §§ 404 and 415.<sup>37</sup>

In order for an S corporation to use an ESOP plan, the corporation must meet the guidelines in § 409(p) of the I.R.C.<sup>38</sup> and the Temporary Treasury Regulations § 1.409(p)-1T(b)(1).<sup>39</sup> If these guidelines are not followed then the fair market value of an improper allocation would be

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<sup>33</sup> *Id.*

<sup>34</sup> See Pratt, *supra* note 11, at 52.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 53.

<sup>37</sup> *Id.* (quoting Daniel L. Simmons & Joseph G. De Angelis, *ESOP-Owned Subchapter S Corporations: A Mistake in Need of a Fix*, 1999 TNT 39-95, Tax Notes Today, Mar. 1, 1999, at 1325).

<sup>38</sup> 26 U.S.C. § 409(p)(1)-(2)(A) (2000). Prohibited allocations of securities in an S corporation.

(1) In general. An employee stock ownership plan holding employer securities consisting of stock in an S corporation shall provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of § 401(a)) for the benefit of any disqualified person.

(2) Failure to meet requirements.

(A) In general. If a plan fails to meet the requirements of paragraph (1), the plan shall be treated as having distributed to any disqualified person the amount allocated to the account of such person in violation of paragraph (1) at the time of such allocation.

<sup>39</sup> Pratt, *supra* note 11, at 53.



treated as gross income subject to a ten percent additional income tax under § 72(t) of the I.R.C.<sup>40</sup>

#### E. *Additional Benefits*

ESOPs are limited in their liability regarding loans made to the ESOP.<sup>41</sup> An exempt loan must be made without recourse to the ESOP. The only assets that are subject to use as payment for liability are assets given as collateral for the loan, contributions made to meet the ESOPs loan obligation, and earnings attributable to the collateral and the investment of those contributions.<sup>42</sup> In the event of default, the ESOP is protected to pay only to the extent of the failure to meet the loan payment amount, because “the value of the plan assets transferred in satisfaction of the loan must not exceed the amount of the default.”<sup>43</sup>

In his article, “ESOP’s Myths, and the Benefits of Employee Stock Ownership Plans,” Harvey Katz discusses many incorrect assumptions about ESOPs. Entrepreneurs may be concerned that using ESOPs may harm the possibility of selling the company in the future to a strategic buyer who offers to pay a generous premium for the company.<sup>44</sup> Katz points out that while this is a possibility in some hot areas of business, most likely the

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<sup>40</sup> *Id.* at 53-54.

<sup>41</sup> 29 C.F.R. § 2550.408b-3(e)-(f) (2005).

(e) Liability and collateral of ESOP for loan. An exempt loan must be without recourse against the ESOP. Furthermore, the only assets of the ESOP that may be given as collateral on an exempt loan are qualifying employer securities of two classes: Those acquired with the proceeds of the exempt loan and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. No person entitled to payment under the exempt loan shall have any right to assets of the ESOP other than:

(1) Collateral given for the loan,

(2) Contributions (other than contributions of employer securities) that are made under an ESOP to meet its obligations under the loan, and

(3) Earnings attributable to such collateral and the investment of such contributions.

The payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years. Such contributions and earnings must be accounted for separately in the books of account of the ESOP until the loan is repaid.

(f) Default. In the event of default upon an exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default. If the lender is a party in interest, a loan must provide for a transfer of plan assets upon default only upon and to the extent of the failure of the plan to meet the payment schedule of the loan. For purposes of this paragraph, the making of a guarantee does not make a person a lender.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Harvey M. Katz, *ESOP’s Myths, and the Benefits of Employee Stock Ownership Plans*, EMPLOYEE BENEFIT PLAN REVIEW, SEPT. 2005, at 5.

owner may encounter some difficulty finding a buyer willing to pay a premium for the company regardless of ESOP usage.<sup>45</sup> Furthermore, the use of an ESOP may prevent a hostile takeover attempt from succeeding.<sup>46</sup> As discussed in the case *Faircloth v. Lundy Packing Co.*,

[u]se of an ESOP provides a corporation with a cheap and ready source of capital that may be used for expansion, to pay down debt, or (as may be the case with a closely-held corporation) to buy out a minority shareholder. . . . ESOPs also may benefit management (sometimes at shareholder expense) by making the corporation more resistant to a hostile takeover. . . . [W]ithin the business community ESOP implementation is largely perceived as a strategy favoring incumbent management.<sup>47</sup>

This rationale was also supported in *NCR Corp. v. American Tel. and Tel. Co.*<sup>48</sup> The court concluded that the incumbent management is in a favorable position because it is assumed that the employees are more likely to vote in favor of management.<sup>49</sup> With the inherent uncertainty that surrounds any new management transition, it is likely that the employees would support the current management. The support of the current management acts as another line of defense against a hostile takeover.<sup>50</sup>

To prevent the owner from suffering a loss on the sale of the business, an ESOP plan can help the owner by allowing him to sell a minority stock position while still retaining control of the business. The owner is able to “cash out” part of his equity in the business at a fair price.<sup>51</sup> This is critical for entrepreneurs who would like to withdraw some of their investment into the business without fully selling their position. Not only will the ESOP prevent the future sale of the business, but it may also act to create a market for the stock of the entrepreneurial venture as the employees now have the ability to buy and sell shares at their will.<sup>52</sup>

Another concern that an entrepreneur may face is that he or she wants to maintain control of the business.<sup>53</sup> Most ESOP plans generally only sell thirty percent of the company’s outstanding shares to the ESOP.<sup>54</sup>

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<sup>45</sup> *Id.* at 6.

<sup>46</sup> 19 AM. JUR. 2D *Corporations* § 2233 (2005).

<sup>47</sup> *Id.* (citing *Faircloth v. Lundy Packing Co.*, 91 F 3d. 648, 662 (4th Cir. 1996)).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* (citing *NCR Corp. v. American Tel. and Tel. Co.*, 761 F. Supp. 475 (S.D. Ohio 1991)).

<sup>50</sup> *Id.*

<sup>51</sup> Katz, *supra* note 44.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

Under § 409(e)(3) of the I.R.C.,<sup>55</sup> the ESOP stock participants are required to vote on major corporate transactions such as consolidation, liquidation, dissolution, or a merger.<sup>56</sup> This requirement would not affect the daily operations of the business. In the ESOP plan, employees only have a right to vote on the shares allocated to the employees' individual accounts.<sup>57</sup> A trustee is appointed to vote on the shares held by the ESOP that have not been allocated, and Employee Retirement Income Security Act ("ERISA") rules require the trustee to vote "solely in the interest of the plan and its participants."<sup>58</sup> Additionally, giving employees a minority shareholder position will not disrupt the day-to-day operations of the business.<sup>59</sup>

Other concerns discussed by Katz involve whether or not employees will actually want to purchase the stock and bear the cost of the ESOP transaction.<sup>60</sup> In an entrepreneurial venture, the entrepreneur must use the ESOP as a tool to attract employees that would like a stake in the success of the business, just as any other business owner would.<sup>61</sup> Addressing the cost issue, Katz determined "[t]he cost of the ESOP administration is somewhat higher than the cost of administering a comparable profit sharing or 401(k) plan. However, these additional costs are far outweighed by the tax benefits available to ESOP sponsors and selling shareholders."<sup>62</sup> The ESOP plan may have higher costs, but the costs are offset by the tax savings that are not available in other plans.

#### F. Risk of Potential Litigation

ERISA places fiduciary duties on board members and trustees of the ESOPs. According to the Chubb Group of Insurance, companies that offer their stock through a stock ownership plan or 401(k) are increasingly at risk for breach of fiduciary duty lawsuits.<sup>63</sup> As Evan Rosenberg of

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<sup>55</sup> *Id.* (citing 26 U.S.C. § 409(e)(3) (2000)). Section 409(e)(3) Requirement for other employers. If the employer does not have a registration-type class of securities, the plan meets the requirements of this paragraph only if each participant or beneficiary in the plan is entitled to direct the plan as to the manner in which voting rights under securities of the employer which are allocated to the account of such participant or beneficiary are to be exercised with respect to any corporate matter which involves the voting of such shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations.

<sup>56</sup> *Id.*

<sup>57</sup> Katz, *supra* note 44.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 7.

<sup>63</sup> Jeffrey Marshall & Ellen M. Heffes, *Litigation: Company Stock Plans More Prone to Suits*, (businessBRIEFS), FINANCIAL EXECUTIVE, June 2005, at 12.

Chubb Specialty Insurance stated “[w]hile many employers find company stock to be a beneficial feature of their employee benefit plans, it may also create a liability exposure for the plan, the company, the plan fiduciaries, directors and officers. . . . The number of fiduciary liability lawsuits continues to grow, fueled by the stock market decline of 2000 to 2002.”<sup>64</sup> Rosenberg’s suggestions for reducing potential litigation and lawsuits by employees in the ESOPs include developing and maintaining an understandable fiduciary structure, communicating thoughtfully and cautiously when discussing company stock with employees, and obtaining a fiduciary liability insurance policy.<sup>65</sup>

In addition to breach of fiduciary duty concerns, there is also a concern of litigation for violations in Internal Revenue Service (“IRS”) filings. The IRS is actively pursuing litigation in the area of abusive ESOPs.<sup>66</sup> Tom Adel, IRS project manager, discussed the pursuit of shutting down abusive ESOPs: “[T]he most blatant abuses involving Subchapter S ESOPs were being treated as violations of the Code’s tax reporting requirements rather than violations of the Code’s plan qualification rules because these ESOPs were considered to be sham structures.”<sup>67</sup> The sham structures shut down by the IRS involved schemes that started with restructuring profitable businesses into two entities.<sup>68</sup> The first entity keeps the original business structure.<sup>69</sup> The second entity is a Subchapter S corporation acting as a management corporation that extracts the income from the first entity and also avoids meeting ownership thresholds for treatment as a controlled group.<sup>70</sup> The owner of the business is then the sole owner of the second entity, the management company, and is given one hundred percent ownership of the management company through the ESOP plan. This structure gives management the ability to shelter the income from the business entity into the ESOP.<sup>71</sup> This scheme has been shut down by Adel and the IRS because of the large amounts of cash involved and through Form 5500 filings, which provide information on the ESOP plan structure.<sup>72</sup> Business owners must be careful to avoid bending the IRS rules when it comes to ESOP transactions, otherwise the owner may face IRS tax adjustments and penalties.

Another area involving ESOPs and IRS litigation is the deductibility of dividends that employers pay to ESOP plans. In 2003, the

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<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> Matthews on 401(k), *supra* note 20.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> Matthews on 401(k), *supra* note 20.

Ninth Circuit held that employers can deduct dividends used to buy their own stock from affiliated ESOPs in *Boise Cascade Corp. v. United States*.<sup>73</sup> IRS officials were not pleased with the result in *Boise* and are concerned that the Ninth Circuit ruling may hurt employees by “exposing employees who belong to ESOPs to involuntary cash-outs and unexpected tax bills.”<sup>74</sup> The IRS was unsatisfied with the ruling in *Boise* and, as a result, proposed regulations that disallow a deduction when payments are made to repurchase employer securities held by an ESOP.<sup>75</sup> Furthermore, the IRS has taken the position that it will litigate this issue in any other circuits because the IRS believes that allowing the deductions for the dividends provides a double tax benefit to employers.<sup>76</sup> Companies that decide to use ESOP plans must be cautious in their treatment of dividends to stock held in ESOP plans.

#### IV. IS AN ESOP THE RIGHT CHOICE FOR AN ENTREPRENEURIAL VENTURE?

While no exact formula for ESOP success exists, there are some factors that help indicate if the use of an ESOP will thrive in an entrepreneurial environment. “Companies that are relatively more labor-intensive than capital-intensive tend to make better ESOP candidates, as do companies that have relatively more predictable cash flows.”<sup>77</sup> This conclusion supports the idea that to have a successful ESOP plan, employees must understand that their stock is directly affected by the company’s profitability and growth.<sup>78</sup> Employees who are working hands-on in the business are likely to benefit from seeing the impact their efforts can make to strengthen the company’s financial future.<sup>79</sup> Another observation of successful ESOP plans occurs in “[c]ompanies that have

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<sup>73</sup> *Boise Cascade Corp. v. U.S.*, 329 F.3d 751 (9th Cir. 2003); see Allison Bell, *IRS Fights Court Ruling Over ESOP Dividends*, NATIONAL UNDERWRITER LIFE & HEALTH, Sept. 19, 2005, at 38. In *Boise*, the corporation brought action against the government seeking federal income tax refund for payments paid to its employee stock ownership plan for redemptions of stock caused by employee terminations. The United States District Court for the District of Idaho upheld the opinion of the magistrate judge and granted summary judgment in favor of the corporation. The Government appealed and lost at the appellate court. The Court of Appeals for the Ninth Circuit held that: (1) plan trust owned stock when redemption took place, and thus allowed the distributions to participants to be deductible as dividends, and (2) distributions to participants were not payments made “in connection with” corporation’s redemption of convertible preferred stock.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 41.

<sup>77</sup> Kramer, *supra* note 2, at 10.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

management infrastructure equipped to handle the compliance requirements of employee benefit plans, and those that have a corporate culture that encourages open communication with employees tend to make better ESOP candidates.”<sup>80</sup>

The flexibility of an ESOP allows it to fit into many different business structures, however, “[a]n ideal ESOP candidate is a C corporation with more than 20 employees, with pretax, pre-discretionary bonus income of \$1,000,000 or more, whose owners seek liquidity and wish to perpetuate the company.”<sup>81</sup> This business structure is ideal because it offers the greatest tax benefits to the owners and the corporation. So long as the transaction qualifies, the sellers sell their stock to the ESOP without paying a capital gains tax.<sup>82</sup> Additionally, a tax benefit is available to the corporation; when the corporation makes a payment to repay the ESOP debt, both the principal and the interest are tax deductible to the company.<sup>83</sup> Depending on the size of the ESOP, the tax savings can be extremely valuable to the corporation.

## V. TYPES OF BUSINESSES BEST SUITED FOR AN ESOP

In the Harvard Business Review article, “*Every Employee an Owner. Really.*” by Corey Rosen et al., Rosen describes entrepreneurial ventures as a type of company that can benefit from the use of employee ownership plans.<sup>84</sup> Rosen identifies young, growth-oriented companies as one of several types of businesses that can benefit from employee ownership.<sup>85</sup> “Plenty of growth oriented, entrepreneurial businesses that aren’t based on high technology have discovered the dot-coms’ secret: [o]ffering equity is a great way to attract and keep high-quality people whom they couldn’t afford otherwise.”<sup>86</sup> When a young company grows fast, its stock appreciates rapidly and employees can build up huge account balances in a relatively short time.<sup>87</sup>

Other business types that Rosen also believed would benefit from an ESOP plan include “destination” workplaces, which are defined as companies with excellent work environments coupled with generous benefits.<sup>88</sup> At these “destination” workplaces, using stock ownership fits into the employee-focused culture.<sup>89</sup> In addition to “destination”

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<sup>80</sup> *Id.*

<sup>81</sup> Buxton & Gilbert, *supra* note 2, at 87.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> Rosen, *supra* note 8, at 127.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

workplaces, companies under threat from outsiders are in a better position to ward off competitive threats through the use of a broad employee ownership plan.<sup>90</sup> Rosen also points out that even an established company can use employee ownership to improve profitability and growth.<sup>91</sup>

The final type of company that would particularly benefit from the use of an ownership plan also has some of the same characteristics present in many entrepreneurial ventures such as companies seeking to create or improve their reputation.<sup>92</sup> Young entrepreneurial companies are looking to establish their firm and their reputation. For these entrepreneurs, using employee ownership can show a commitment to the company's success and dedication to employees.<sup>93</sup>

Employee ownership sets a company apart on an ethical level. . . . Young companies, in particular, have little or no track record to point to; for them, employee ownership conveys the message that the founders did not enter the business just to make a quick buck. Indeed, employee vigilance in an ownership-based company that is financially and operationally transparent makes pursuing a quick or questionable buck difficult.<sup>94</sup>

If, after evaluating the ESOP plan, the entrepreneur decides that using ownership to compensate his or her employees is a good decision for the company, but finds that the ESOP plan may not be best suited for the company, there are other employee compensation plans available. Several of the most popular plans are discussed below.

#### *A. Stock Option Plan*

This plan allows employers to offer unlimited options to purchase stock for vested employees by locking in a price to purchase the stock during a specified window of time.<sup>95</sup> An estimated seven million to ten million employees in both public and private companies currently hold stock options.<sup>96</sup>

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<sup>90</sup> Rosen, *supra* note 8, at 127.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> Rosen, *supra* note 8, at 123.

### B. *Restricted Stock Plan*

The restricted stock plan is similar to the stock option plan because it allows vested employees to purchase stock either at the fair market value or at a discounted price, but often there is the additional requirement that the employee continue to work for the company in the future.<sup>97</sup> The most common restricted stock plan requires the employee to continue to work for the company for a certain length of time and the shares purchased under the plan are forfeited should the employee leave before meeting the time requirement.<sup>98</sup>

### C. *Employee Stock Purchase Plan*

A qualified employee stock purchase plan (“ESPP”) also gives employees the chance to buy stock, often through payroll deductions, generally over a three-month to twenty-seven-month offering period.<sup>99</sup> Because the stock in ESPPs is often offered at a discount, the possibility exists that employees can profit from the purchase of the stock even if the market price has declined since the grant date.<sup>100</sup>

A nonqualified employee stock purchase plan, a company may sell shares of its stock to employees, and this sale is not subject to the qualification rules that apply for ESPPs.<sup>101</sup> Due to the technicalities in meeting qualification for ESPPs, many companies choose to use the nonqualified plan, but as a result, these companies lose the favorable tax treatment associated with ESPPs.<sup>102</sup>

### D. *Section 401(k) Plan*

A § 401(k) plan is designed to provide the employee with a diversified portfolio of investments rather than the company’s stock alone.<sup>103</sup> A company may choose to match employee contributions into a 401(k) plan alone, or the company may choose to contribute stock as well as a 401(k) plan, which is known as a KSOP plan—a combination of an ESOP with a 401(k) plan.<sup>104</sup>

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<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> Rosen, *supra* note 8, at 123.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*



### E. *Synthetic Equity Provisions and Stock Appreciation Rights Plans*

Both synthetic equity provisions and stock appreciation rights plans provide employees with a cash payout determined by the increase of the company's stock over a particular time.<sup>105</sup> Synthetic equity provisions that pay cash do not have the same complexities that surround plans offering stock, but the trade-off is losing the employee's sense of ownership.<sup>106</sup>

## VI. CONCLUSION

ESOPs are one alternative to compensate employees for entrepreneurs and provide entrepreneurs an exit strategy when the entrepreneurs are ready to leave the corporation without putting the company at the risk of ending its business. ESOPs have significant advantages because of their favorable tax treatment, both for the corporation and for the shareholders associated with the ESOP plan. ESOPs must be used with caution, especially for closely-held corporations, because of the potential for tax avoidance abuse. For many entrepreneurial businesses, ESOPs offer a way to build company morale and can often improve profitability and growth. It is worth evaluating whether or not an ESOP plan fits into an entrepreneurial business because of the financial incentives, and an ESOP's ability to help to hire and retain good employees.

If the entrepreneur decides that using an ESOP plan is not in the best interest of the company but still wishes to use an employee ownership plan, the Committee for Effective Employee Ownership<sup>107</sup> produced several guiding principles:<sup>108</sup>

1. Effective equity compensation strategy is driven as much as possible by empirical data on what works, rather than on theory, assumptions and doing what other companies do.
2. To be effective, equity compensation allocates equity among executive, management and non-management employees fairly and in a broad-based manner.
3. Broad-based equity plans should generally provide equity to a majority of full-time employees.
4. Executive ownership in public companies should be determined by an independent committee using rigorous guidelines.

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<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> Rosen, *supra* note 1, at 12. The Committee for Effective Employee Ownership is a joint project of the National Center for Employee Ownership, the Beyster Institute for Entrepreneurial Employee Ownership and the Global Equity Organization. The committee's objective is to broaden the use of employee ownership to extend to more than just the top executives at a company.

<sup>108</sup> *Id.*

5. Companies should provide for diversified retirement opportunities as well as company equity ownership, such as a 401(k) plan or adequate diversification within an employee ownership plan.
6. Public companies should provide adequate disclosure to investors and employees about equity plans. It is impossible to know from public filings whether a company has a broad-based plan unless it voluntarily discloses it.
7. Public companies' plans should be fair to shareholders as well as employees.

These guidelines should be considered both in the formation stage and throughout the lifetime of an employee ownership plan. This note can be a useful resource to entrepreneurs in determining whether or not to use employee ownership, and in particular, an ESOP plan. However, in making the decision whether or not to use employee ownership, the entrepreneur must invest a great deal of time into evaluating the transactional costs against the tax and other advantages. The information on ESOPs and other employee ownership plans can often be presented with bias either in favor of ownership or against it. To guarantee effective decision making, the entrepreneur should seek guidance from professionals familiar with both sides of the employee ownership debate.